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Nos. 06-1457 and 06-1462

In the Supreme Court of the United States

MORGAN STANLEY CAPITAL GROUP INC. and
CALPINE ENERGY SERVICES, L.P., *et al.*,
Petitioners

v.

PUBLIC UTILITY DISTRICT NO. 1 OF SNOHOMISH COUNTY
WASHINGTON, *et al.*, and
FEDERAL ENERGY REGULATORY COMMISSION,
Respondents

On Writs of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., AND THE FINANCIAL INSTITUTIONS ENERGY GROUP AS *AMICI CURIAE* SUPPORTING PETITIONERS

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BRIEF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., AND THE FINANCIAL INSTITUTIONS ENERGY GROUP AS *AMICI CURIAE* SUPPORTING PETITIONERS

INTEREST OF THE *AMICI CURIAE*[1]

The International Swaps and Derivatives Association, Inc. (ISDA), is the largest financial trade association in the world, representing leading participants in the privately negotiated derivatives industry. It was chartered in 1985, and includes more than 780 member institutions from 54 countries on six continents. These members include most of the world's major institutions that deal in, and are leading end users of, privately negotiated derivatives, as well as many of the businesses, governmental entities, and other end users that rely on derivatives to manage efficiently the financial market risks inherent in their core economic activities. Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business.

The Financial Institutions Energy Group (FIEG) is a group of investment and commercial banks, all of which play a vital role in the electric utility industry. The businesses of FIEG members (and their affiliates) as they relate to the energy sector are very diverse. They are directly involved in the purchase and sale of electric energy, capacity, and ancillary services, and

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici curiae*, their members, or their counsel made a monetary contribution to its preparation or submission.

many are power marketers with market-based rate authority. They are also involved in a wide array of other businesses that are only incidentally related to the electric industry. For example, FIEG members may act as market-making dealers, participants in physically and financially settled derivative transactions designed to hedge certain counterparty risk or to establish a proprietary position in the market, arrangers of loan facilities, and underwriters of debt and equity securities.

Members of ISDA and FIEG are substantial participants in the market for wholesale electric power sales. Some members own interests in companies that produce electric power and sell it in the wholesale market. Some own interests in retail distribution companies that purchase power in the wholesale market and distribute it to end users. Predominantly, however, the members of *amici* operate as traders in the wholesale market; they contract with power producers, distribution companies, and other traders to buy or sell wholesale power that will ultimately be produced or distributed by others.

These firms play an extremely important role in wholesale power markets. Their expertise and their extensive trading operations allow them to mitigate financial risks. For example, by assembling a diverse portfolio of contractual obligations to buy and sell power at different times and at different prices, these firms can insulate themselves from many of the risks of temporary price volatility as well as longer term unfavorable price trends. Perhaps more important, by contracting with producers and distributors of power, these firms allow the producers and distributors to avoid

those risks. A simple, classic example is a long-term contract pursuant to which a trader sells power at a fixed price to a retail distributor. The contract assures the buyer a stable supply of power at a guaranteed price. The risk that prices will rise over the duration of the contract is transferred to the seller, which may be better positioned to mitigate that risk through its extensive trading operations and its expertise in managing financial risk.

The broad participation of traders has helped to create a vibrant and efficient market for wholesale power that provides other important benefits. The market – especially because of the participation of large traders – enhances liquidity in the sale of electric power, so that retail distributors can readily find sources of supply and producers can readily find buyers for power. In addition, a well-functioning market enhances the transparency and efficiency of prices, both short term and long term, thereby enabling buyers and sellers to respond more rapidly and efficiently to changing market conditions.[2]

In an important way, traders are unlike other participants in the wholesale market. Power producers generally participate in the wholesale market as

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[2] Recent empirical studies discuss the benefits of trader participation in energy markets. See Michael S. Haigh, Jeffrey H. Harris, James A. Overdahl & Michael A. Robe, *Market Growth, Trader Participation and Pricing in Energy Futures Markets* (Feb. 7, 2007), available at http://web.uvic.ca/econ/robe.pdf; Michael S. Haigh, Jana Hranaiova & James A. Overdahl, *Price Dynamics, Price Discovery and Large Futures Trader Interactions in the Energy Complex* (April 28, 2005), available at http://cftc.gov/files/opa/press05/opacftc-managed-money-trader-study.pdf.

sellers; distribution companies generally participate as buyers; but traders tend, over the long term, to be neither net sellers nor net purchasers of power. Traders generally seek to purchase only the power they can sell, and to sell only what they can purchase. Thus, they have no vested interest in rules that systematically favor sellers or buyers. Their interest, instead, is in rules to ensure that *the market* operates effectively. An efficient and properly functioning market will benefit all market participants – both buyers and sellers – and, indirectly, end users of electricity, whose interests are served by the efficient production and distribution of electric power.

To function effectively, the wholesale power market *requires* clear, stable, and enforceable contract rights. Such rights are essential for any market to function effectively, but they are particularly important in the market for electric power, which depends on long-term investments and contractual sales involving hundreds of billions of dollars every year. Clear and enforceable contract rights are especially important to ensure broad participation in the market by firms other than producers and distributors of power. Producers and distributors, if they wish to remain in business, must sell and buy power. But firms that function principally as traders have choices about the extent to which they will participate in this market. A regulatory environment that impedes their ability to manage risk, by creating uncertainty about contract enforcement, will encourage them to commit their capital to other markets that entail less risk. If that is allowed to happen, the cost to the electric power industry, and to the

public (which depends on that industry daily), will be very large.

For more than half a century, decisions of this Court have protected the legitimate economic expectations of participants in this market, by making clear that, when parties choose to enter into a contract to buy or sell power, their agreement will be enforced even if, in hindsight, the agreement turned out to be unfavorable to one or more contracting parties. The Ninth Circuit's decisions are fundamentally at odds with that principle. Because of their members' unique role in this market, *amici* are well positioned to explain why reversal of those decisions is necessary to prevent market dysfunction that will impose enormous costs on the American public.

SUMMARY OF ARGUMENT

This Court's landmark *Mobile*, *Sierra*, and *Memphis* decisions have for a half-century guided parties to negotiate energy contracts with the understanding that such contracts will be enforced even if changes in the marketplace render them unprofitable for one party. Clear, simple, and predictable rules that give *contracting parties* – not regulators – flexibility to deal with varied situations have stimulated necessary investment, by permitting all parties to rely on the enforceability of contractual commitments unless there are "circumstances of unequivocal public necessity" that justify abrogation of a contract. *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968).

The decision to honor contracts is not a departure from the statutory command that each and every rate be "just and reasonable." Rather, the key insight of

Mobile and *Sierra* is that there is generally a strong reason to presume that a rate established by *agreement* between buyer and seller *is* just and reasonable, even if the rate differs from a cost-based rate that the Commission might impose in the absence of a contract. At least in the absence of market power (which the Commission found does not exist in this case in the forward markets at issue), market forces can be counted on to do a *better* job than a regulator – and certainly a better job than a regulator applying cost-of-service ratemaking principles – of establishing just and reasonable rates. The Ninth Circuit's view that only rates preapproved by a regulator can be presumed just and reasonable reflects both faulty economics and a misreading of this Court's cases.

Market "dysfunction" of the kind asserted here is no basis for the abrogation of contacts either. The alleged "market dysfunction" here is that illegal activity and other unusual conditions in the spot markets led to increases in the prices for long-term contracts in the western States. But no illegal activity in the forward markets is alleged – rather, respondents and the Ninth Circuit wish to equate high prices with "dysfunction." But in *properly* functioning markets prices rise in response to increases in demand, scarce supply, and price increases in adjacent markets. It is socially *desirable* – it *serves* the public interest – for market participants to sell power at the prices market conditions dictate. It makes no sense to discourage those sales – thereby exacerbating shortages and upward pressure on rates – by creating uncertainty that the seller will get the benefit of its bargain.

Indeed, consumers will be harmed if an amorphous "market dysfunction" standard can be used to reduce the predictability that the *Mobile-Sierra* doctrine has afforded for 51 years. Such a standard will discourage the use of long-term contracts, which play an important role in promoting investment in new productive assets and in mitigating market volatility. The "market dysfunction" standard will discourage the production and sale of electric power when it is *most* needed to respond to shortages. The "market dysfunction" standard will deprive buyers of their power to negotiate lower rates by forgoing the inclusion of a clause in their contracts that allows regulators to reexamine rates during the life of the contract. The "market dysfunction" standard will lead to enormous litigation costs as predictable rules are replaced with an extremely vague standard for allowing escape from contractual rates. And, reflecting all of those deleterious effects and others, a "market dysfunction" standard will tend to raise the costs, reduce the financial rewards, and increase the risks of companies that produce electric power or trade in wholesale power markets, thus driving productive capital from the market, to consumers' ultimate detriment.

ARGUMENT

I. Because Contract Rates Presumptively *Are* Just And Reasonable Rates, Participants In The Wholesale Power Market Justifiably Rely On The Enforceability Of Contracts

Since three landmark decisions by this Court in the 1950s, long-term contracts for wholesale electric power sales (and natural gas sales) have been

negotiated with the understanding that such contracts could be enforced even if changes in the marketplace rendered the contract unprofitable for one of the parties. Buyers and sellers have negotiated contracts and made long-term investments worth hundreds of billions of dollars in reliance on that clear and simple principle.

In *United Gas Pipe Line Co.* v. *Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956), this Court held, unanimously, that a natural gas company could not unilaterally modify a contract rate by filing a new rate with the Federal Power Commission. After carefully analyzing the text of the Natural Gas Act ("NGA"), 15 U.S.C. §§ 717 *et seq.*, the Court concluded, "[E]xcept as specifically limited by the Act, the rate-making powers of natural gas companies were to be no different from those they would possess in the absence of the Act." 350 U.S. at 343. Among other powers, natural gas companies could "fix by contract, and change only by mutual agreement, the rate agreed upon with a particular customer." *Ibid.* The Act did not permit parties to escape their contractual obligations – even with the Commission's approval – "simply because it is in their private interests to do so." *Id.* at 344.

The Court followed and extended the *Mobile* decision in another unanimous decision on the same day. *FPC* v. *Sierra Pacific Power Co.*, 350 U.S. 348 (1956), arose under the Federal Power Act ("FPA"), 16 U.S.C. §§ 791a *et seq.*, the relevant provisions of which were "substantially identical" to the provisions of the NGA that were construed in *Mobile*. 350 U.S. at 353. *Sierra* answered a question that was not presented in *Mobile*. In *Sierra*, the Commission had found that the rate

established by contract was unlawful, because it did not provide a sufficient rate of return under the cost-based standard that the Commission used, in the absence of a contract, to determine whether a rate was "just and reasonable." This Court held that the Commission's finding was "based on an erroneous standard." *Id.* at 354. Even if a rate could not be imposed by the Commission in the absence of contract, "it does not follow that the public utility may not itself agree by contract to a rate affording less than a fair return or that, if it does so, it is entitled to be relieved of its improvident bargain." *Id.* at 355. A contract rate is not unjust and unreasonable "simply because it is unprofitable to the public utility." *Ibid.* A rate established by contract is unjust and unreasonable only if it would "adversely affect the public interest – as where it might impair the financial ability of the public utility to continue its service, cast upon other consumers an excessive burden, or be unduly discriminatory." *Ibid.*

Mobile and *Sierra* involved efforts by sellers to increase rates charged to buyers, but two years later this Court confirmed that the decisive principle is that contracts must be enforced, not that the financial interests of buyers take precedence over the financial interests of sellers. *United Gas Pipe Line Co.* v. *Memphis Light, Gas & Water Division*, 358 U.S. 103 (1958), held that a seller could unilaterally raise contract rates by filing the new rates with the Commission, when the contract permitted the seller to do so. "The important and indeed decisive difference between this case and *Mobile* is that in *Mobile* one party to a contract was asserting * * * the right unilaterally to abrogate its contractual undertaking, whereas here peti-

tioner seeks simply to assert * * * rights expressly reserved to it by contract." *Id.* at 112.

After *Memphis*, the *Mobile-Sierra* doctrine has been invoked repeatedly as a rate-neutral doctrine, which prevents both increases and reductions of contract rates. See, *e.g.*, *Potomac Elec. Power Co.* v. *FERC*, 210 F.3d 403 (D.C. Cir. 2000) (refusing to reduce a utility's contractually established transmission rate to the level in the utility's open-access tariff); *Public Serv. Comm'n of the State of New York* v. *FPC*, 543 F.2d 757, 798 (D.C. Cir. 1974) (holding that the Commission is no more at liberty to alter a contract "to the prejudice of the producers than to do so in their favor"). As then-Judge Scalia pointed out in *Kansas Cities* v. *FERC*, 723 F.2d 82, 88 (D.C. Cir. 1983), a rule that contracts must be enforced is not harmful to consumers because "permitting liberal Commission alteration [of contracts] will favor the seller when costs have increased." See also *Papago Tribal Utility Authority* v. *FERC*, 723 F.2d 950, 955 (D.C. Cir. 1983) ("*Papago II*") ("adoption of a strict or lenient standard for rate change * * * does not necessarily favor either [utilities or consumers] since its effect will depend upon whether upward or downward revision is sought").

Mobile, *Sierra*, and *Memphis* established rules that are clear, simple, and predictable, and that emphasize the *contracting parties'* – not the regulators' – flexibility to deal in various ways with disparate situations. Under those rules, buyers and sellers may contract for rates that can be modified only in extraordinary circumstances, under the *Sierra* "public interest" standard. But they are also free to include in their contract a so-called "*Memphis* clause" that permits rates to be

modified (at the request of the buyer, the seller, or either), with the Commission's blessing, to conform to a cost-based "just and reasonable" standard (as in *Memphis*), or other standards on which the parties agree. See, *e.g.*, *Richmond Power & Light* v. *FPC*, 481 F.2d 490 (D.C. Cir. 1973) (permitting parties to negotiate contracts that tied wholesale rates to retail rates); *Papago Tribal Utility Authority* v. *FERC*, 610 F.2d 914 (D.C. Cir. 1979) ("*Papago I*") (permitting parties to contract for a rate change mechanism that would prohibit rate increases under FPA § 205, 16 U.S.C. § 824d, but allow changes under § 206, 16 U.S.C. § 824e). The *Mobile-Sierra* rules are both predictable and "refreshingly simple: The contract between the parties governs the legality of the filing. Rate filings consistent with contractual obligations are valid; rate filings inconsistent with contractual obligations are invalid." *Richmond Power & Light*, 481 F.2d at 493.

Mobile and *Sierra* were solidly grounded in the text and purpose of the Natural Gas Act and the Federal Power Act. The statutes "expressly recognize[] that rates to particular customers may be set by individual contracts," *Mobile*, 350 U.S. at 338, and the statutes' explicit references to contracts carry the "obvious implication" that, "except as specifically limited by the Act," binding rates could be established through contracts to the same degree as would be permitted "in the absence of the Act." *Id.* at 343. These statutes, unlike some other regulatory schemes, "built the regulatory system on a foundation of private contracts." *Sunray Mid-Continent Oil Co.* v. *FPC*, 364 U.S. 137, 154 (1960). The Natural Gas Act and Federal Power Act are "premised on contractual agreements

voluntarily devised" and "contemplate[] abrogation of [those] agreements only in circumstances of unequivocal public necessity." *In re Permian Basin Area Rate Cases*, 390 U.S. 747, 822 (1968). As the Solicitor General's brief in *Mobile* explained, gas and electric companies "typically require[d] substantial investment in capacity and facilities for the service of the particular customers. Consequently, gas and power companies' relations with their customers are ordinarily first arranged by contract." Brief of Petitioner at 52-53, *FPC* v. *Mobile Gas Serv. Corp.*, 350 U.S. 332 (1956) (No. 31). In these industries, "preserving the integrity of contracts * * * permits the stability of supply arrangements which all agree is essential." *Mobile*, 350 U.S. at 344.

The statutory prohibition of rates that are "unjust, unreasonable, unduly discriminatory or preferential," 16 U.S.C. § 824e(a), has been construed to effectuate this central feature of the Acts. Rates offered to the public *in the absence of a contract* are generally considered to be just and reasonable if they permit the seller to recover the cost of providing service (including a reasonable return on investment). See generally *Verizon Communications, Inc.* v. *FCC*, 535 U.S. 467, 480-488 (2002) (discussing evolution of "just and reasonable" standard). But, in a regulatory system built on a foundation of private contracts, the starting presumption – especially if the parties have not negotiated a "*Memphis* clause" as described above – is that the "just and reasonable" rate *is* the contract rate. The requirement of "just and reasonable" rates cannot be construed as an authorization to modify contract rates merely because they do not satisfy a cost-based standard. If the re-

quirement were so construed, the Commission would have the same rate-making authority when parties have contracted to establish rates that it would have in the absence of a contract, and industry participants would have little ability to structure their economic relationships through contracts, rather than through a cumbersome regulatory process. See *Town of Norwood, Mass.* v. *FERC*, 587 F.2d 1306, 1313 (D.C. Cir. 1978) ("the simple fact that parties protected by * * * a contract pay less than those not so protected [cannot be] grounds for revision, for if it [were] *Sierra* would provide scant protection to the contracting process").

Respondents in the present case have sought to erect a false dichotomy between "just and reasonable" rates and contract rates, implicitly suggesting that a rate, even if established by contract, can be just and reasonable *only* if it complies with a cost-based measure that the Commission could impose in the absence of a contract. *E.g.*, Public Utility District No. 1 of Snohomish County Br. in Opp. 14 ("Snohomish Br. in Opp.") ("this Court in *Mobile* and *Sierra* nowhere said that rates are immune from the statutory command that rates be just and reasonable just because they were adopted in contracts"); see also *id.* at 8 (characterizing FERC's decision as having upheld the contractual rates "without * * * determining whether the Western Utilities' contracts were unjust and unreasonable"). The proposition for which the *Mobile* and *Sierra* cases stand is not that contract rates are immune from the statutory command, but that they *meet* the statutory command that rates be just and reasonable, unless some extraordinary "public interest" justification – some "circumstance[] of unequivocal public necessity,"

Permian Basin, 390 U.S. at 822 – exists so that a court or agency deem rates unjust or unreasonable even though the contracting parties freely agreed to them.

Contract law reflects the conclusion that it is *just* to enforce contractual commitments. Contract enforcement may threaten the private interests of parties who come to regret their contractual commitments, but enforcement serves the broader public interest in protecting economic expectations. See, *e.g.*, *Cities of Bethany* v. *FERC*, 727 F.2d 1131, 1139 (D.C. Cir. 1984) ("the preservation of private contracts within the context of a rate-setting statutory scheme promotes economic stability"). The public interest in contract enforcement is significant here because the Commission's power to ensure just and reasonable rates is based on the need to "protect[] the public interest, as distinguished from the private interests of the utilities." *Sierra*, 350 U.S. at 355; see also NGA § 1, 15 U.S.C. § 717 ("the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest"); FPA § 201, 16 U.S.C. § 824 ("the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest"). If the Commission's authority over rates is intended to protect the *public* interest, there is no reason to construe a requirement of just and reasonable rates as an implicit authorization to protect *private* interests by rewriting a contract so that a party may be "relieved of its improvident bargain." *Sierra*, 350 U.S. at 355 (citing *Arkansas Natural Gas Co.* v. *Arkansas Railroad Comm'n*, 261 U.S. 379 (1923)).

The existence of a contract, in and of itself, likewise supports a presumption that the contract terms

are *reasonable*. Contract law generally presumes that the terms of a contract reflect a reasonable accommodation of the parties' respective interests; otherwise they would not have entered the contract. See *Verizon*, 535 U.S. at 479 ("In wholesale markets, the party charging the rate and the party charged were often sophisticated businesses enjoying presumptively equal bargaining power, who could be expected to negotiate a 'just and reasonable' rate as between the two of them.").

Lower courts and private parties have long understood *Mobile* and *Sierra* to extend broad protection to contractual expectations and, until the Ninth Circuit's decision in this case, the continued breadth and vitality of those decisions has never been seriously threatened. As Judge Boudin observed for a unanimous First Circuit panel, "[t]he *Mobile-Sierra* doctrine has hung over the electric power and natural gas industries since 1956, and the two cases are probably among the dozen best-known public utility decisions by the Supreme Court in this century." *Boston Edison Co.* v. *FERC*, 233 F.3d 60, 66 (1st Cir. 2000). The cases, and the broad principle of contract protection they established, have been described as "landmark[s]," *Cities of Campbell* v. *FERC*, 770 F.2d 1180, 1187 (D.C. Cir. 1985), "well-settled and oft-invoked," and "powerful * * * where it applies," *East Kentucky Power Co-op, Inc.* v. *FERC*, 489 F.3d 1299, 1309 (D.C. Cir. 2007). See also *Consol. Edison Co. of New York, Inc.* v. *FERC*, 165 F.3d 992, 1002 (D.C. Cir. 1999) ("settled doctrine"); *Vermont Dep't of Public Service* v. *FERC*, 817 F.2d 127, 132 n.15 (D.C. Cir. 1987) ("'well-settled doctrine'") (quoting *Holyoke Water Power Co.* v. *FERC*, 799 F.2d 755, 755 (D.C. Cir. 1986)); *New England Power Co.* v. *FERC*, 571 F.2d

1213, 1216 (D.C. Cir. 1977) ("well settled" standard); *Towns of Alexandria, Minn.* v. *FPC*, 555 F.2d 1020, 1030 n.55 (D.C. Cir. 1977) ("settled law").

Contracting parties have understood that, as a matter of practical reality, "[t]he obstacle that the public-interest standard presents to a rate change is almost insurmountable." *Kansas Cities*, 723 F.2d at 87-88. Accord *Papago II*, 723 F.2d at 954 ("practically insurmountable").[3] That fact imposes no hardship, because parties that wish to permit modifications in contract rates in the face of changed circumstances are free to negotiate a contract with a *Memphis* clause that permits either or both of the parties to seek rate modifications through the Commission. An opposite conclusion, however, would disserve the public interest and impose tremendous hardship, as freely entered contractual relations could not be counted on to justify capital investments or other resource commitments necessary to produce power in needed amounts.

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[3] Most cases finding that modifications were required under the "public interest" standard have involved modifications necessary to effectuate regulatory policy decisions broadly affecting the industry, *not* modifications in response to claims of economic hardship resulting from the terms of specific contracts. See, *e.g.*, *Permian Basin*, 390 U.S. at 784 (upholding Commission's abrogation of thousands of contracts in order to establish an area-wide geographic system of setting natural gas rates); *FPC* v. *Louisiana Power & Light Co.*, 406 U.S. 621, 646 (1972) (upholding Commission's alteration of contracts in response to nationwide shortage of natural gas). See also *United Distrib. Cos.* v. *FERC*, 88 F.3d 1105 (D.C. Cir. 1996) (upholding Commission's termination of contracts in order to prohibit the bundling of gas and transportation), cert. denied, 520 U.S. 1224 (1997).

The *Mobile-Sierra* doctrine developed during a period when wholesale power supply was the exclusive domain of large, vertically integrated entities that possessed or were assumed to possess market power. That is the situation in which there is the least justification for presuming that contractual rates are just and reasonable. When the party that has supposedly negotiated an advantageous contract has market power, the basic premise justifying traditional cost-of-service regulation of rates (instead of giving free rein to market forces) is at its strongest. See, *e.g.*, *Louisiana Energy & Power Auth.* v. *FERC*, 141 F.3d 364, 365 (D.C. Cir. 1998); Hon. Joseph T. Kelliher, *Market Manipulation, Market Power, and the Authority of the Federal Energy Regulatory Commission*, 26 ENERGY L.J. 1, 8-13 (2005). See generally STEPHEN BREYER, REGULATION AND ITS REFORM 15-16, 242-244, 285-286 (1982). Even so, case after case has applied the *Mobile-Sierra* doctrine to protect the sanctity of contracts – and to encourage investments based on a well-grounded expectation that contracts will be enforced – even when the complaint is that the agreed-to rates were allegedly too high. See page 10, *supra*.

Here, the Commission specifically found – and the Ninth Circuit did not and could not overturn the finding – that petitioners *lack* market power in the forward markets at issue. See 06-1457 Pet. App. 265a-266a ("The need for prior Commission review in these circumstances was met when, after determining that [Morgan Stanley, Calpine, and others] lacked market power or had taken steps to mitigate it, the Commission authorized all of the Respondents [petitioners here] in this proceeding to make sales of power at

market-based rates. * * * The 'just and reasonable' standard of Section 205(e) of the FPA is satisfied by the Commission's determination that the utility * * * lacks market power or has taken sufficient steps to mitigate market power.") (footnotes omitted). The absence of market power is *still more* reason to accept that the contract rates are just and reasonable, yet the Ninth Circuit thought that the mere theoretical possibility of market changes in between the Commission's determination that a seller lacks market power and the seller's entry into a contract was a sufficient basis to make the *Mobile-Sierra* doctrine inapplicable. 06-1457 Pet. App. 52a-57a. That conclusion was erroneous.

By limiting application of the *Mobile-Sierra* doctrine to situations in which the Commission engaged in old-style review of contractual rates, rather than relying on economic principles and a finding of lack of market power, the Ninth Circuit made a choice that was not the judiciary's to make and effectively usurped the valid choice of FERC to recognize that market forces produce *more* just and reasonable rates than regulators in the absence of market power. See 06-1457 Pet. App. 51a (castigating FERC for not doing enough "to ensure that the [contract] rates were within the statutory 'just and reasonable' range in the first instance"). In the absence of market power in the forward markets at issue, FERC validly presumed that the contract rates *are* just and reasonable. And, as we discuss in the next two sections, the amorphous claim of the existence of market "dysfunction" is no valid basis to overcome the presumption.

II. Buyers Should Not Be Permitted To Escape Contractual Commitments Because The Contract Was Negotiated During A Period Of Market Dysfunction

Respondents argue that they should be relieved of their contractual commitments because they negotiated the contracts during a period of market dysfunction. See, e.g., Snohomish Br. in Opp. 11, 15. That argument rests on fundamental misconceptions about how markets operate, and how they *should* operate. A legal standard that excuses buyers from contractual commitments made in a period of market dysfunction is unworkable and undesirable.

The market "dysfunction" here began with a dramatic increase in prices in the California spot market, which was attributed to (1) unusually high demand for electricity, caused by unusually high temperatures, (2) a scarcity of generation capacity throughout the west, and in California in particular, (3) buyers' excessive reliance on spot-market purchases, due to a confluence of regulatory policies, and (4) illegal manipulation of spot-market prices by some participants in that market. 06-1457 Pet. App. 23a-25a; see also FERC Br. 9 (filed Nov. 21, 2007). High prices in California led to price increases in other western States. And, although FERC stated that there is "no evidence to support a finding of market manipulation that specifically affected the contracts at issue" here (06-1462 Pet. App. 344a), this case has been litigated on the assumption that high prices in the spot market – as opposed to more typical market fluctuations like increased demand in response to high temperatures and decreased supply in response to regulatory policies – may have led to an

increase in prices in the market for forward contracts, including the contracts at issue here. 06-1457 Pet. App. 57a-58a. Even if that assumption were correct, the Ninth Circuit's effort to require FERC to inquire into market "dysfunction" before applying the *Mobile-Sierra* doctrine would be misguided.

To describe the facts of this case as involving market dysfunction requires market dysfunction to be falsely equated with high prices. In *properly* functioning markets, prices rise in response to increases in demand, scarce supply, and price increases in adjacent markets to which buyers turn for substitutes. That prices rise in such conditions, even that they rise dramatically, is, on its face, an indication that the market is operating as it should. It is not a dysfunction when markets follow the laws of supply and demand.

That conclusion is buttressed here by the absence of any suggestion that petitioners engaged in any market manipulation or other improper conduct that affected the contracts. See, *e.g.*, 06-1457 Pet. App. 271a, 301a. Similarly, there is no evidence of unfairness, bad faith, or duress by petitioners in the contract negotiations. *Id.* at 33a. And there is no evidence that any of these petitioners had, or exercised, market power in the forward markets. For each of the contracts at issue, the buyer obtained multiple competing offers, and entered the contract voluntarily because the terms of the contract seemed advantageous at the time. See, *e.g.*, 06-1457 Pet. App. 161a-166a (describing Snohomish contract negotiations); 06-1462 Pet. App. 340a-341a, 345a-346a (same); FERC Br. 43. The market conditions in which the contracts were negotiated were conditions affecting both buyers and sellers. Both had equal

knowledge of those conditions; neither had the ability to change them. The sellers were not at fault and, when the contracts were negotiated, there was no more reason to think that the sellers had made a good bargain than there was to think that the buyers had done so. Each contract was entered only because both parties thought it would be advantageous to their interests, and both parties knowingly took the risk that a more advantageous rate might have become available in the future if the parties had not locked themselves into a long-term rate based on their needs and perceptions at that time.

It makes no sense to describe the market for forward contracts as dysfunctional even if, as the Ninth Circuit assumed, it was influenced by illegal manipulation of prices in the spot market. If market manipulation has created an artificial shortage, higher prices will encourage other market participants to alleviate that shortage by increasing the level of market supply. It is socially *desirable* – it affirmatively serves the public interest, and cannot be described as "unjust" or "unreasonable" in any normal sense of those words – for other market participants to sell at the higher price. By doing so, they minimize the harm caused by the market manipulation and reduce the wrongdoers' illicit gains.[4] It makes no sense to *discourage* those addition

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[4] See Charles Augustine, Joseph Cavicchi & Joseph Kalt, *Competition and Regulation, Part III, Tensions Evolve Between Regulation and Competition*, ELECTRIC LIGHT AND POWER (Jan. 2006), available at http://uaelp.pennnet.com/Articles/Article_Display.cfm?Section=ARTCL&ARTICLE_ID=247218&VERSION_NUM=2&p=34 ("[A]s our antitrust principles recognize, if a dominant seller, A, unlawfully exercises market power, its prices

al sales by creating uncertainty that the seller will get the benefit of its bargain. *That* policy – not the *Mobile-Sierra* policy of enforcing the contractual commitments that buyers make to sellers – will create market dysfunction by preventing the market from responding as it should to market manipulation.

Respondents' (and the Ninth Circuit's) view that *Mobile-Sierra* should not protect contracts negotiated during a period of market "dysfunction" is fundamentally at odds with the logic and purpose of the *Mobile-Sierra* doctrine. Even if that view were based on a narrow conception of "dysfunction" – for example, the existence of market manipulation by others – sellers would face a risk that virtually any contract could be undone. No innocent seller can know at the time it is negotiating a contract whether *other* sellers are engaged in market manipulation. Such conduct, by its nature, is concealed from innocent sellers, as well as buyers and regulators. The only evidence of market "dysfunction" that will be apparent to buyers and sellers at the time of their contract is volatile prices. But buyers and sellers cannot know whether that volatility reflects natural forces of supply and demand – in which case the market is not truly dysfunctional in

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can properly be judged to be unjust and/or unreasonable. At the same time, however, these principles recognize that A's exercise of market power will generally pull up the prices of otherwise faultless sellers B, C, D . . . Z, and will induce expansions in those sellers' supplies. In market-driven price regimes, this is desirable: The responses of B, C, D . . . Z dampen the impact of A's conduct and hold overall price levels lower than they would be if these other sellers did not respond. B, C, D . . . Z's prices may be 'high' but B, C, D . . . Z's responses help consumers.").

any meaningful sense of the word – or improper market manipulation. And there is no workable benchmark with which to determine how high or how volatile prices must be in order to trigger a conclusion that the market is dysfunctional. Is the market "dysfunctional" if prices are 20% higher than some historical average? One hundred percent higher? Two hundred percent? Does it matter whether the higher prices persist for only a few days? Or for months or years?

If market "dysfunction" can justify a departure from *Mobile-Sierra* principles, clear and definite answers to these questions are essential, so that market participants, when negotiating contracts, can sensibly assess the risks that the contract will entail. The Ninth Circuit made no effort to answer those questions. If this Court affirms the decision of the Ninth Circuit, the result will be that the Commission has "discretion on remand to consider all relevant factors in determining whether the contracts at issue should be upheld or reformed." FERC Br. in Opp. 12 (filed Aug. 6, 2007). A remand thus could – conceivably – lead to the right result for petitioners, but it would be an unmitigated disaster for the certainty and predictability that drive economic activity in this industry and that have been assumed throughout the more than 50 years since this Court decided *Mobile* and *Sierra*. To refer to "discretion" to "consider all relevant factors" is to admit that there is *no* test for when market "dysfunction" exists or what its legal effects on any particular contract are, only an open-ended set of considerations that could lead to practically any result. The adoption of such a contentless standard will *create* market distortions and

inefficiencies, with long-term detriment to the public interest.

III. A Market Dysfunction Standard Will Harm Consumers By Impeding The Efficient Operation Of The Wholesale Power Market

Markets cannot operate efficiently unless contracting parties can have confidence that contractual commitments will be enforced, even if, with the benefit of hindsight, the contract turns out to have been unfavorable to one of the parties. If buyers can be relieved of their contractual commitments because their contract was negotiated during a time of supposed market "dysfunction," sellers' confidence in the enforceability of contracts will be seriously undermined

That effect will be especially acute if the specific conditions in this market are deemed to constitute a "dysfunction" that allows these particular contracts to be set aside. In this case, it is clear that any "dysfunction" was not caused by the sellers' behavior. There is no suggestion that the sellers had or exercised market power or that the contract negotiations were tainted by fraud or duress. If these contracts are abrogated, it will be for reasons *entirely* beyond the control of the sellers. Moreover, by its nature, a "dysfunction" standard can be applied only with the benefit of hindsight. Thus, at the time they are negotiating contracts, sellers cannot even *know*, let alone control, whether the contract ultimately will be enforceable. Finally, at least in the Ninth Circuit's conception, the "dysfunction" standard will be applied asymmetrically. Buyers may be able to escape their contractual commitments to "high" rates, while sellers would be bound

by their contractual commitments to "low" rates. See, *e.g.*, 06-1457 Pet. App. 65a (deeming it sufficient to require a remand that "the contract could cause customers to pay higher rates than they would have without the contract" – a standard that will be met in every case of a bargain that appears disadvantageous in hindsight). The adoption and application of a market dysfunction standard under which these contracts could be abrogated will predictably and *inevitably* create distortions and inefficiencies in the future operation of wholesale power markets.

First, such a standard will discourage the use of long-term contracts. The degree of financial risk to sellers will increase in proportion to the duration of the contract. That is because of the risk that, if market prices decline over the duration of the contract, the seller may lose the benefit of the contract price, because the buyer may be able to obtain a reduction in the contract price from FERC on the basis of market dysfunction; but, if market prices rise over the duration of the contract, the application of traditional *Mobile-Sierra* standards would prevent the seller from obtaining modifications to the unfavorable price. If a contract locks in a price for a very short period of time, there will be little opportunity for market prices to move dramatically in either direction, and therefore little financial exposure to the seller as a result of the buyer's "heads I win, tails you lose" advantage.

The large element of risk that would be added to long-term contracts will have many undesirable effects. Long-term contracts play an important role in promoting investment in new productive assets. A power producer considering whether to undertake a major

capital investment to increase its generating capacity (or a bank that is considering whether to finance that investment) is more likely to do so if it can secure long-term contracts to sell power at a price that would ensure an adequate return on its investment. See *Mobile*, 350 U.S. at 344 (parties cannot be expected to make "substantial investments * * * without long-term commitments" and such commitments are impossible if "supply contracts are subject to unilateral change"); *Memphis*, 358 U.S. at 113 (Without legal protection of producers' contract rights, "the maintenance and expansion of their systems through equity and debt financing would become most difficult, if not impossible."). Long-term contracts similarly play an important role in facilitating investments by buyers, who may rely on long-term price commitments as insurance that their investments will be profitable. See *Mobile*, 350 U.S. at 344 (discussing importance of long-term commitment to buyers' investment decisions). They are also an important tool that is used by market participants to hedge against the risk of unfavorable price movements.

Long-term contracts also tend to mitigate market price volatility and, in some situations, the risk of market manipulation. There is no small irony that buyers' excessive reliance on spot-market purchases was one of the causes of the high prices in this case, and that replacing spot-market purchases with purchases under long-term contracts was an important means of *reducing* those prices. 06-1457 Pet. App. 24a-25a. Perversely, the standard advocated by respondents will undermine sellers' incentives to offer long-term contracts, which will again push buyers towards

an excessive reliance on short-term purchases. See FERC Br. 44-45.

Second, the Ninth Circuit's decisions will discourage the production and sale of electric power when it is *most* needed to respond to shortages. The elementary laws of supply and demand teach that shortages lead to higher prices, and that *severe* shortages lead to *much* higher prices. Sensible policy – policy that serves consumers' best interests – would seek to encourage suppliers to sell more electric power when prices spike upwards, in order to alleviate the shortage and reduce prices. A market "dysfunction" standard will do just the opposite. Under that standard, the contractual commitments that sellers can *least* rely on are the commitments that buyers make when market prices have spiked upwards. When market prices are exceptionally high, the likelihood that prices will later decline – leading buyers to seek price reductions through the regulatory process – is at its greatest, and a market characterized by unusually high prices is most likely to be described, retrospectively, as "dysfunctional." When consumers would benefit the most from sellers' agreements to provide more power – when market prices have spiked upwards – a market dysfunction standard will create the greatest disincentive for sellers to enter into such agreements.

Third, a market dysfunction standard will deprive future *buyers* of a contracting option that will result in *lower* prices. The Ninth Circuit seemingly suggested, albeit vaguely, that a market should be deemed dysfunctional if market prices are greater than the price FERC could impose under a cost-based "just and reasonable" standard, and that buyers should be entitled

to price reductions under such circumstances.[5] But buyers are free to contract for the ability to seek reductions of contract rates to that level even if there is no market dysfunction exception to the application of *Mobile-Sierra* principles. Buyers can negotiate for the inclusion of a *Memphis* clause that would permit them to petition FERC for rates that would conform to a cost-based just and reasonable standard. A contract that provides such protection to *buyers*, however, will be less attractive to *sellers* than a contract in which buyers cannot seek future rate reductions. For that reason, sellers almost certainly will insist on a higher contract rate if the contract gives buyers that option, and will offer buyers a lower rate if buyers forgo that option.

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[5] The Ninth Circuit's statement that "a high-rate public interest determination should focus on whether consumers' electricity bills have been affected by the challenged rates – * * * whether those bills are higher than they would otherwise have been had the challenged contracts called for rates within the just and reasonable range" (06-1457 Pet. App. 64a) would be unobjectionable *if* what the Ninth Circuit meant by the "just and reasonable range" were the same thing the Commission means – freely negotiated rates that reflect neither the exercise of market power nor market manipulation by the sellers. But the Ninth Circuit instead betrayed its inability to conceive of a "just and reasonable" rate as anything other than a cost-based rate when it relied on *FPC* v. *Texaco Inc.*, 417 U.S. 380, 399 (1974) – a case in which the existence of market power was *assumed* and contracted-for rates were not even at issue – for the proposition that "even 'a small dent in the consumer's pocket' is relevant to the determination of fair rates." 06-1457 Pet. App. 64a. And, when the Ninth Circuit *applied* its standards, it abandoned all pretense of looking at anything other than whether consumers' prices were higher than they would have been in the absence of the contracts. *Id.* at 65a-66a.

In practical terms, the market dysfunction standard that the Ninth Circuit adopted would impute to every contract, as a matter of law, a *Memphis* clause that would allow buyers to seek future rate reductions if contract rates exceeded the level of cost-based just and reasonable rates. Because that "protection" would be extended to every contracting buyer as a matter of law, sellers would not be able to offer lower contract rates to induce buyers to forgo that protection – even if buyers would prefer to have lower contract rates and would eagerly forgo the benefits of a *Memphis* clause to obtain those lower rates.

The contracts at issue here did *not* include *Memphis* clauses under which buyers could unilaterally seek rate reductions from FERC. There is no indication that buyers were precluded from negotiating for such rights. To the contrary, both FERC and the Ninth Circuit found that the buyers *waived* such rights in the contracts. 06-1457 Pet. App. 42a-46a; see also FERC Br. 45. But the Ninth Circuit failed to recognize the obvious implication of that fact: that, by waiving such rights, respondents almost certainly obtained lower contract rates, and that the current litigation is an effort by respondents to have their cake and eat it too.

It would be inequitable to *these* sellers to adopt a legal rule that allows *these* buyers to obtain, through litigation, rights that they voluntarily waived in their contract negotiations. But the prospective effect of such a rule will be harmful to future sellers *and* to future buyers. Future sellers will be deprived of the ability to bargain for a contract that provides certainty that negotiated rates will remain in effect for the duration of the contract. Future buyers will be deprived of the

ability to bargain for the lower contract rates that will be available *only* if sellers have that certainty.

Fourth, a market dysfunction standard will lead to enormous litigation costs. When the *Mobile-Sierra* doctrine is properly applied, litigation over long-term supply contracts is rare and relatively cheap. The principal issue to be decided is whether the disputed contract is valid. That issue frequently can be decided merely by examining the contract or, in unusual cases, the behavior of those who were involved in negotiating the contract, to determine if they acted deceptively or in bad faith. The use of a market dysfunction standard will expand both the circumstances in which buyers will be motivated to initiate litigation to escape their contractual commitments, and the scope and likely cost of that litigation. Instead of applying well-settled principles of contract law to determine the validity of the contract, the litigation will now address the amorphous question whether the market was "dysfunctional" when the contract was negotiated – a question that may require examination of a wide array of economic and regulatory conditions and the conduct of other market participants. If that inquiry leads to the conclusion that the market was dysfunctional, the litigation must also determine the effects of the market dysfunction, *i.e.*, the amount by which the contract rate exceeds what a court or agency somehow determines is a *more* "just and reasonable" rate than the contract rate. These enhanced litigation costs will be especially burdensome for firms that are principally traders. In this intensely competitive business, profit margins are modest and will be substantially eroded if those contracts that are most favorable to the seller can be en-

forced, if at all, only by spending large sums on litigation.

Fifth, in all of these respects and others, a market dysfunction standard will tend to raise the costs, reduce the financial rewards, and increase the risks of companies that produce electric power and companies that trade in wholesale power markets. Sellers in the wholesale power market (and not just the sellers in these particular contracts) will experience these harmful effects in the first instance. Inevitably, however, the effects on sellers will cause the supply of electric power to be reduced and its price driven up. A failure to enforce respondents' contractual commitment will immediately harm petitioners, but ultimately will cause far greater harm to the efficient operation of the market for wholesale electric power, and to the consumers of electric power who are the beneficiaries of an efficient market.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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